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DIRECTORATE OF
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Intelligence Memorandum

Ceylon: Current Economic Situation

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1971

INTELLIGENCE MEMORANDUM

CEYLON: CURRENT ECONOMIC SITUATION

Introduction

1. The surprisingly large and well-organized insurgency that surfaced in Ceylon in April 1971 had thrived on a deteriorating economic situation. Much of its popular support apparently derived from the effects of rising unemployment and living costs and chronic shortages of consumer goods. Ceylon's economic problems are rooted deeply in the island's growing indebtedness – both foreign and domestic – as successive governments have opted to continue expensive social welfare programs despite declining export receipts and sluggish economic growth. This memorandum analyzes the underlying economic causes of the current situation, discusses corrective measures attempted by the Bandaranaike government during its first year in power, and examines the principal economic policy options now available to the government.

Discussion

Background

2. The Ceylonese have traditionally enjoyed one of Asia's highest standards of living – although still low by Western standards. Numerous free and heavily subsidized goods and services are available, including free rice and other subsidized foodstuffs, and free health care and education. These social welfare programs date back to the colonial period and – since independence in 1947 – have been reduced at times only at substantial political cost to the party in power. In 1966, for example, the moderate Senanayake government cut the rice subsidy in half, a step that may have been decisive in its subsequent defeat at the polls in 1970.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

3. During the colonial period and for several years after independence, exports of tea, rubber, and coconut financed steadily increasing imports of consumer goods. In the mid-1950s, however, the world price of tea, which accounted for 60% of export receipts, began to decline (see Figure 1). Subsequently, in the 1960s the prices of Ceylon's imports – particularly rice – increased and caused a rapid deterioration in Ceylon's terms of trade (see Figure 2). Changes in export and import volume were not significant enough to offset the price influences, and the trade deficit persisted. Most of the shortfall had to be financed by drawing down foreign exchange reserves, as foreign aid was negligible. By 1960, however, reserves had fallen to less than half their 1955 level and Ceylon became increasingly dependent on foreign assistance. Disbursements of foreign aid increased from about $17 million in 1960 to $29 million in 1965, then expanded rapidly to $65 million by 1970 (see Figure 3). The expansion of the late 1960s was spurred by the Western aid consortium with the United States as the principal donor (see the table). Ceylon's foreign debt, which rose at an average annual rate of 11% during 1955-65, increased by 24% annually during the ensuing five-year period. Moreover, an increasing proportion of this debt was composed of suppliers' credits and other short-term, high interest obligations, and debt service problems mounted.

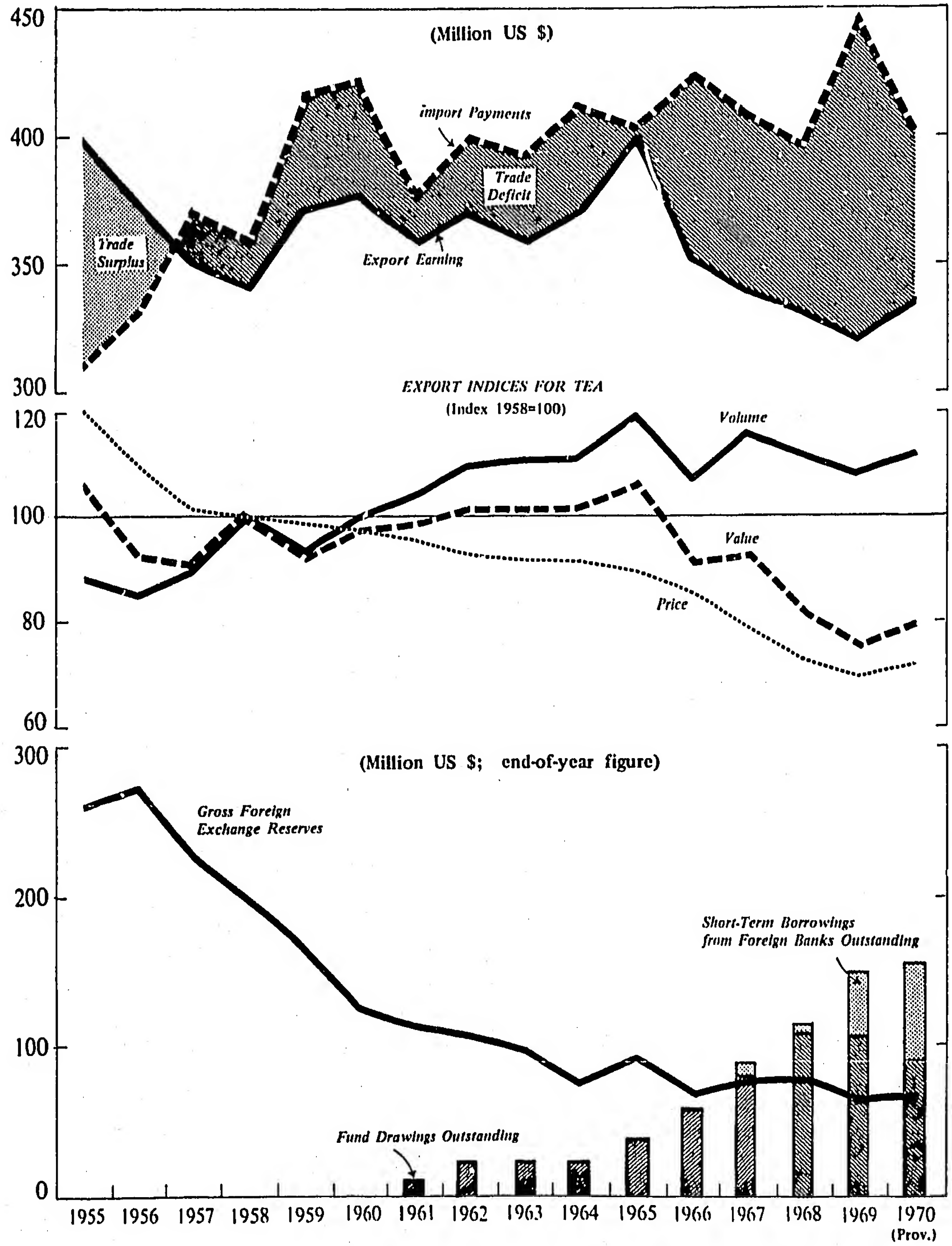
4. The rapid increase in foreign aid in the late 1960s permitted Colombo to turn its attention – at least temporarily – to accelerating economic growth. The moderate administration of Dudley Senanayake (1965-70) cut the rice subsidy in half, devalued the currency, and relaxed some government controls over imports as well as over private economic activity. Growth of gross domestic product averaged 5-1/2% during 1966-70, up from 3-1/2% in the early 1960s, in part because of the increased investment generated by the additional foreign aid, much of which was used to finance agricultural inputs and capital goods imports.

5. Meanwhile, the government's budget deficit increased rapidly during the latter 1960s, and by 1970 represented 23% of government expenditures. In that year, only one-fourth of the deficit was financed by foreign sources, compared with 45% the previous year. Domestic sources of finance were mainly commercial banks. Such expansionary fiscal policy contributed to the current inflationary pressures in Ceylon. Colombo's Consumer's Price Index, 1/ which had previously been fairly stable,

1. The Colombo Consumer's Price Index, which is the only available price and cost of living index in Ceylon, has several serious shortcomings: it is generally based on the consumption pattern of Colombo working class families as revealed in a family budget survey during 1949-50 which is now considered out-of-date. Furthermore, items such as food and rent for which the prices are subsidized or controlled have a relatively heavy weight in the Index. Consequently, the Index tends to understate overall price increases.

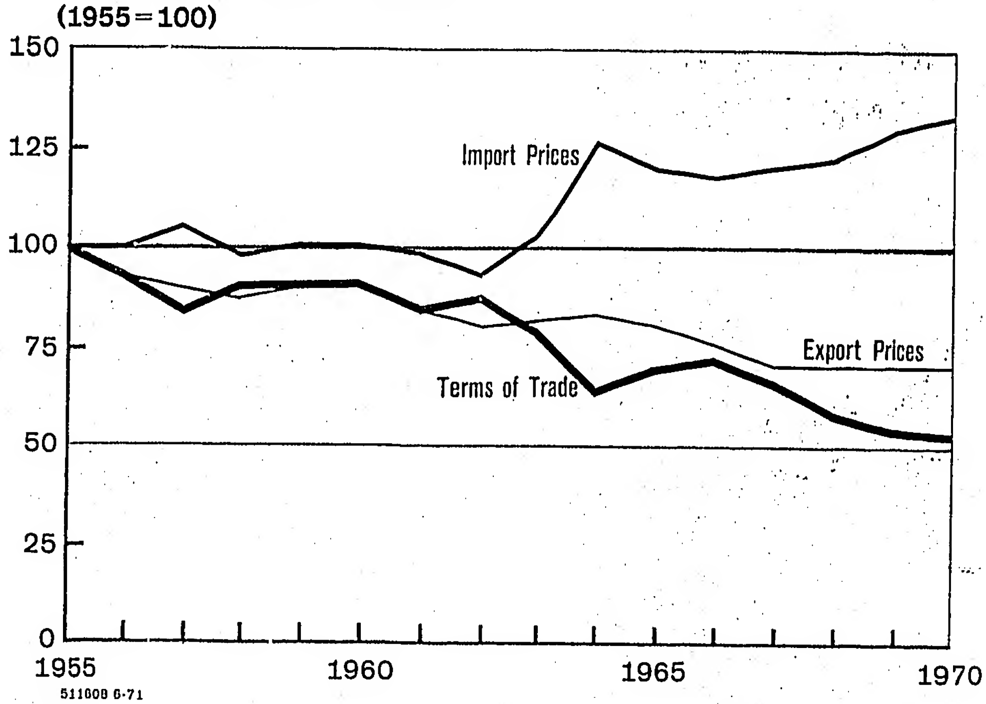
FIGURE 1

MERCHANDISE TRADE DEVELOPMENTS AND FOREIGN EXCHANGE RESERVES



Ceylon: Terms of Trade

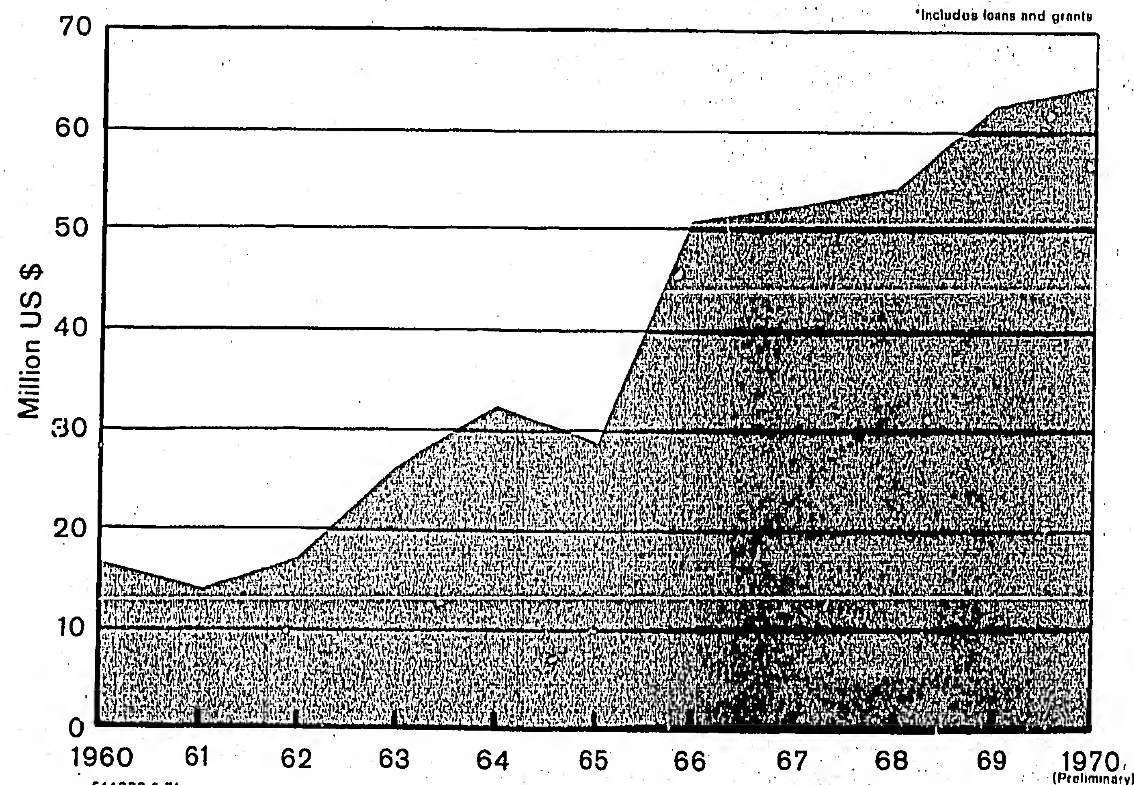
Figure 2



Ceylon: Aid Receipts*

Figure 3

*Includes loans and grants



Ceylon: Foreign Aid Receipts, by Source

	1960-64		1965-69	
	Million US $	Percent of Total	Million US $	Percent of Total
Aid consortium	15.8	29	170.9	84
United States	6.4	12	53.2	26
United Kingdom	4.8	9	35.2	17
Federal Republic of Germany	4.0	7	33.9	17
Japan	0	0	18.6	9
Others a/	0.6	1	30.0	15
Communist countries	19.0	36	27.4	14
German Democratic Republic	--	--	14.0	7
Peoples' Republic of China	5.9	11	4.0	2
USSR	12.1	23	7.3	4
Poland and Yugoslavia	1.0	2	2.1	1
IBRD	19.0	35	4.6	2
Total	*53.8*	*100*	*202.9*	*100*

a. Including Canada, Denmark, France, and Italy.

registered a 7% gain during 1968, 6% in 1969, and about 6% in 1970. In 1969, rents – which had been frozen for over a decade – were adjusted upward by an average of 8.2%. In 1970, especially steep increases in the prices of imported goods as well as of such essential items as food and firewood were recorded. Shortages became more frequent for items under government price control – mostly foodstuffs such as flour and sugar – and black market activity increased as did consumer dissatisfaction.

6. Along with price increases and shortages of various goods, unemployment continued to plague the labor market, increasing from about 11% in 1968 to 15% by 1970. Unemployment was concentrated among the young, with about two-thirds of the unemployed under 25 years of age. Furthermore, almost 40% of the unemployed had at least a secondary education, reflecting the imbalance between the subsidized system of humanities-centered education and the country's manpower needs. As in other developing countries in Asia, many of Ceylon's educated youth prefer to remain unemployed rather than take jobs they consider menial. This pool of educated, jobless, and disenchanted youth apparently constituted a fertile medium for the growth of the radical activists, popularly called the Che Guevarists, who were reportedly responsible for the widespread insurgency.

Policies of the Present Administration

7. Since taking office in May 1970, Mrs. Bandaranaike has pursued economic policies dictated by political expediency. To underline its "socialist" tendencies, the new government increased consumer subsidies, tightened the state's control over the private sector, and extended the hegemony of the public sector. These measures served only to erode private business confidence and worsen the government's domestic and international financial situation.

8. In September 1970 the new government fulfilled its major campaign promise by doubling the weekly rice ration to four pounds, but simultaneously imposed a 12¢ charge for the second two pounds to reduce the government's costs. Nevertheless, an additional budgetary drain of about $10 million was generated by the change. Moreover, the additional import requirements of the doubled ration – primarily to build up government stocks – will cost an estimated $5 million in foreign exchange.

9. To enhance her socialist image, Mrs. Bandaranaike had also made sweeping campaign promises to expand the scope of the public sector by nationalizing banks and plantations. While she was forced to temper her socialist ambitions, she did, immediately after taking office last summer, broaden state control over imports by suspending the Open General License

scheme and tightly regulating all import applications. Total imports fell sharply in 1970, but the entire drop was in capital goods, as consumer goods imports actually rose slightly. In November 1970 the government takeover of the import and distribution of motor vehicle tires drove the US-owned Firestone plant out of operation. A month later, Shell, Esso, and Caltex were forced to relinquish their bunkering facilities and a US-owned advertising company left the country, apparently because of the Bandaranaike government's repressive policies toward foreign-owned firms.

10. Further inroads into the trade sector were made by the establishment of the State Trading Corporation (STC) in December 1970. The STC has already taken over about 70% of the imports previously handled by the private sector -- worth nearly $60 million annually -- and is authorized to absorb the rest eventually. Its enabling legislation provided it with the authority to take over any private firm if necessary "to further the purpose of the Corporation" and at least one such takeover has already occurred. In the export sector the STC's activities are mainly limited to servicing existing barter agreements, which presently involve most of the exports that are sold to Communist countries -- about one-fourth of the total. The STC, together with the quasi-public Cooperative Wholesale Establishment, also has taken full responsibility for the wholesale distribution of consumer commodities and competes with private businessmen in retail trade. In many of these activities, however, the private sector's role was already relatively small, so that most of the changes brought about through the creation of the STC have involved coordination of existing state-owned or state-controlled agencies.

11. Perhaps the new government's most ominous initiative was the passage of the Business Undertakings Acquisition Bill, scheduled to take effect in September 1971. This act provides the government with almost unlimited authority to acquire any private firm and property. There are no provisions for judicial review or for compensation. Despite repeated government assurances that this bill will be used only against companies trying to fire workers or suspend operations unnecessarily, its passage undoubtedly undermined private investor confidence even further.

12. Apprehension in the private sector also has been heightened by the government's choice of fiscal policy tools. Rather than making a realistic effort to deal with budgetary imbalance by reducing current expenditures, the administration erected a facade of ideologically appealing but economically insignificant revenue generating measures. Most of these were aimed at the higher income groups. The business turnover tax, excise duties, and import tariffs were made more progressive and a one-shot capital levy was imposed – affecting only those with a net wealth of over $33,600. Mrs. Bandaranaike also demonetized large-denomination currency and

introduced a compulsory savings scheme for those with annual incomes over $1,000. All of these measures combined, however, will barely offset the fall in revenue in 1971 expected from declines in customs duties and tax receipts.

Economic Effects of the Insurgency

13. On 5 April 1971, scattered attacks on police stations and transportation and communication centers triggered the widespread insurgency that unexpectedly shook this complacent tropical island. A variety of economic disruptions resulted from the insurgency. The virtual paralysis of Colombo's port in the early days of the fighting and reduced working hours caused later by the curfew resulted in a decline in port receipts which are a source of government revenue. A loss in income from public enterprises resulted from their reduced operations and from the commandeering of many of their trucks and other transport vehicles for military uses. The island's largest textile mill, a cement plant, and the graphite mines were among the firms closed down by the insurgents. The government nationalized the Bogala graphite mines in mid-May to insure their renewed operation, and after a month of paralysis the textile mill resumed operations but at reduced capacity. The combination of these effects reportedly has resulted in a $17 million revenue loss to the budget.

14. Meanwhile, military expenditures increased by about two-thirds to about $27 million on an annual basis. The inadequately trained and poorly equipped Ceylonese armed forces were caught unprepared by the uprising and scrambled to obtain supplies and to recruit personnel. Considerable aid from abroad arrived in response to Colombo's widespread appeals for help – including the United States, the USSR, India, the United Kingdom, Yugoslavia, and Pakistan. In addition, because the insurgents have gone underground and a protracted struggle is anticipated, the Ceylonese military has asked that its annual budget be increased to over $100 million. In addition to increased military expenditures, the repair or replacement of destroyed telecommunications equipment, police stations, and public utilities will cost an estimated $1.5 million.

15. The foreign exchange implications are perhaps the most serious economic consequences of the insurgency. Some of the fighting took place in the area around the tea plantations, and transportation to the coast was disrupted temporarily. Even the tea which reached the ports underwent long delays in loading, and the disruption of the timber industry created a shortage of tea chests for shipping. As a consequence, tea sales in April reportedly hit a record low, and it is unlikely that losses can be completely recouped later in the year. Revenue from tourism was also down by at least $1.5 million from the previous year, and there was a dearth of summer

bookings for winter holidays. Meanwhile, additional foreign exchange is likely to be required for equipment replacement and repair of the transportation and communication channels. The paralysis of the textile and cement factories will necessitate increased imports of those essential commodities. In addition, the foreign exchange costs of military goods are likely to be considerable.

Prospects for Policy Changes

16. The additional strain that the insurgency has placed on Ceylon's resources has brought the need for economic reform into sharper focus. Shortly after the insurgency began, Mrs. Bandaranaike announced that severe austerity measures were in order if only to pay for additional military expenditures and restore damaged areas. At the meeting of the Western aid consortium in April, Ceylon's finance minister hinted at major policy changes that would be responsive to the consortium's suggestions for belt-tightening. He indicated in particular that resources were to be shifted from consumption to investment in an effort to accelerate economic growth and that a reduction in the rice ration was under consideration.

17. Unless the government is prepared to reduce the island's living standards markedly, however, Ceylon will remain heavily dependent on foreign aid – at least for the next several years. Mrs. Bandaranaike has given no indication that she intends to impose a broad-based austerity program soon. On the contrary, she told the US Ambassador in mid-June that she has no plans to reduce the rice ration at this time and indicated that she is concentrating on reforms relating to income distribution rather than economic growth. However, she also stated that she plans to introduce fees for health and educational services that would represent a beginning toward narrowing the budget deficit.

18. Foreign aid requirements are increasing because of the dim prospects of reducing imports or increasing exports at least in the short run, thus widening the trade deficit. About three-fifths of Ceylon's imports in 1970 were consumer goods, and, although the government now has fairly complete control over imports, to reduce these would be difficult since they consist primarily of foodstuffs. Exports are likely to decline this year because of the disruptions from the insurgency as well as declining markets for Ceylon's tea and rubber.

19. Prospects for increased foreign aid are uncertain. Representatives of the consortium nations at the April meeting agreed that their aid in 1971 would be "somewhat higher" than 1970's $65 million. Actual commitments are likely to be lower, however, as most members have not yet signed bilateral aid agreements and apparently are waiting for some

clarification of Colombo's economic plans. Communist China, which for many years has had a rice-rubber barter agreement with Ceylon, gave the government an interest-free $25 million loan in May, to be used at Colombo's discretion. This is the first non-project aid obtained by Ceylon from a Communist country. Despite this windfall, total aid receipts in 1971 are likely to fall far short of the $107 million Ceylon hoped to obtain to cover its budgetary requirements. The squeeze will be on, therefore, for the government to choose between expansionary financing -- with inflationary pressures -- and reduced government spending. A third alternative -- short-term loans from foreign banks -- has been used increasingly in recent years but may not be available because of Ceylon's deteriorating credit position.

20. Over the long term it will be necessary somehow to restore the island's external balance. Much of the food which is now imported -- accounting for 35% of total imports -- could be produced domestically with appropriate government incentives. An attempt to achieve self-sufficiency in rice, which has been underway for nearly a decade, has shown impressive results. 2/ Between 1965 and 1969, rice production increased at an average annual rate of nearly 13%, and as a result the average volume of rice imports dropped 24% from the previous five-year average. Nevertheless, rice imports still consume about $40 million annually in foreign exchange, and sugar accounts for more than $25 million more. An expanded program of farm input subsidization and increased farm support prices -- although costly in the short-run -- could be implemented to increase domestic production and reduce the exchange drain. Promotion of the fishing industry could also eliminate the $15 million that the island spends annually on imported fish. Aside from food imports, the major opportunity for import substitution is in petroleum. Explorations with the Soviet experts have produced favorable indications of off-shore deposits which, when developed, could turn Ceylon's $25 million annual exchange drain for petroleum into a surplus.

21. Avenues for export expansion include revitalizing the tea and rubber industries through greater use of fertilizer and replanting with higher yielding varieties, but the depressed state of world markets for those commodities renders the returns uncertain. It is unlikely that Ceylon could compete successfully in manufactured products for export because of the relatively high labor costs, low productivity, and scarcity of raw material inputs. Promotion of the island's tourist potential has received much attention in the local press, but actual earnings from increased tourist traffic have been modest -- $3.6 million in 1970 -- and repercussions from the insurgency problem have adversely affected that infant industry. The

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brightest possibility for expanding exports lies in the country's large forest reserves, which include teak, satinwood, and ebony. Nearly 45% of the island's total area is covered by forests, yet almost no lumber is exported, and it has been estimated that the present rate of industrial logging exploitation could be tripled before annual removals would exceed annual forest growth.

22. Apart from eliminating the trade deficit, attracting private foreign investment is another alternative for balance-of-payments relief. This has been attempted in developing the island's latent tourist attractions by approving two joint-venture hotel-building projects involving American and British firms. A five-year tax holiday and the privilege of 15 years of paying taxes at half the normal rate were extended by the government, but these benefits apply only to hotel construction. In other sectors the official policy is to promote "Ceylonization" of industry, which translates into purging foreign interests from existing enterprises as well as denying entry into new projects. Even if Mrs. Bandaranaike would reverse this popular policy, however, it is doubtful that she could entice enough foreigners to invest in Ceylon to ameliorate the balance-of-payments problem much. The previous government encouraged foreign private investment through tax incentives and guarantees against nationalization but was still unsuccessful in reversing the net disinvestment which has been a feature of the Ceylonese economy since independence.

Conclusions

23. The current problems of inflation and unemployment are merely the domestic symptoms of deeper problems in Ceylon's external sector. Perpetuating a high level of public welfare measures in the face of declining world demand for Ceylon's agricultural exports in the last decade has generated increasingly larger budget deficits. At the same time, supplying the sizable and expensive imports of consumer goods necessary to feed and satisfy the public has driven the balance-of-payments deficit to unsupportable levels. As exchange reserves approached exhaustion in the early 1960s, foreign aid and domestic borrowing were increasingly used to bridge the gap, but the resulting increase in the debt burden became a further drain on the country's foreign exchange and internal resources.

24. In its first year in office the Bandaranaike government has done virtually nothing to resolve the island's economic problems. Soak-the-rich taxing policies and tightened controls over the private sector have eroded business initiative. The scope of the inefficient public sector has been enlarged through nationalization and consolidation. Restriction of capital

rather than consumer goods imports dried up industrial inputs. Then with the outbreak of violence in April, the budget vise tightened. Essential revenue from public enterprises and port charges was lost while expenditures – especially military – mounted. Disrupted tea trade and the virtual halt in tourism brought in lowered foreign exchange earnings while demands for it increased.

25. In the coming years, increasing the island's output of such foodstuffs as rice and sugar and developing its possible offshore oil potential may significantly reduce the foreign exchange drain. Revitalizing the export crops sector, cultivating the country's tourist allure, and exploiting its forest reserves could generate the revenue necessary to pull Ceylon's balance of payments out of the red. However, import substitution and export expansion are essentially long-run solutions. Over the next few years, barring the introduction of a far-reaching austerity program, Colombo's budget deficit is likely to widen even further. Maintaining import levels and social welfare expenditures will require increased foreign aid which, in turn, may not be forthcoming – at least from Western donors. The Western consortium has taken a dim view of the government's increasing harassment of the island's private sector and of Colombo's failure to initiate basic economic reforms.

26. In the short run, Mrs. Bandaranaike's options are quite limited, inflationary pressures and high unemployment are certain to continue, and foreign exchange shortages may force some belt-tightening as imports have to be cut back. Because of these economic factors, popular dissatisfaction with the government – already on the increase – could spark a recurrence of this spring's insurgency and threaten the stability of the Bandaranaike regime.

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